Consumer Federation of America
1620 I Street, N.W., Suite 200 * Washington, DC 20006

Testimony of
Travis Plunkett, Legislative Director
Consumer Federation of America

Before

The U.S. House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law

H.R. 5637, the Non-admitted and Reinsurance Reform Act of 2006

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Good morning Chairman Cannon, Ranking Member Watt, and the members of the Committee. My name is Travis Plunkett and I am the Legislative Director of the Consumer Federation of America (CFA). CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education.

I appreciate the opportunity to testify before you on the Non-admitted and Reinsurance Reform Act of 2006 (H.R. 5637.) This is a proposal of great complexity that raises a number of significant legal questions that we urge the Subcommittee to examine carefully. In an effort to make regulation of non-admitted insurance lines and reinsurance more uniform, the bill would establish a feeble and complex oversight regime that will provoke states to compete against each other, to weaken oversight in some cases, and that could leave consumers who have been harmed by insured companies vulnerable in the event of a company's insolvency. CFA is very concerned about the effect of this bill on the insurance market and consumers.

Background

H.R. 5637 is a sharply scaled-back version of the State Modernization and Regulatory Transformation Act (SMART) discussion draft offered by Representatives Baker and Oxley last year. The initial SMART proposal would have preempted and eliminated state oversight of insurance in many important areas, such as the regulation of insurance rates, without establishing strong, uniform federal consumer protection standards. This bill, which was initially only one of 17 titles in the SMART Act, preempts states only in the regulation of surplus lines of insurance and reinsurance.

H.R. 5637 would provide for a method of collecting state premium taxes for surplus lines and allocating this income to the states. It would give deference to the regulations of the home state of the entity purchasing an insurance policy from a non-admitted insurer and in regulating surplus lines brokers. Further, the bill would adopt the model law developed by the National Association of Insurance Commissioners regarding eligibility requirements for surplus lines carriers on a national basis, preempting state laws. It allows large buyers of insurance to get surplus lines coverage without having to show, as most states require today, that a search of the licensed market was made and no coverage was found. The bill also requires the Government Accountability Office (GAO) to conduct a study of the non-admitted insurance market not later than 30 months after the Act takes effect.

Reinsurance would be regulated only by the home state of the ceding primary insurer. All other states would be prohibited from enforcing extra-territorial authority under their laws. Solvency regulation would be conducted by the state of domicile of the reinsurance company.

Taxes on surplus lines insurers are currently levied through licensed surplus lines brokers in each state, who keep track of the premiums they write per state, a much simpler system than that proposed in this bill. The regulation of surplus lines carriers occurs by requiring brokers to make a meaningful attempt to get a licensed carrier for a client before seeking surplus lines coverage, as licensed carriers are regulated by each state. Customers of parties insured by licensed carriers are protected in the event of insolvency by the insured entity in each state through the existence of guarantee associations. Surplus lines carriers must submit data to each state that requests it to be included on that state's list of approved insurers.

Serious Policy and Legal Questions Surround the Preemption and Interstate Compact Provisions of H.R. 5637

CFA has not examined the Constitutional and legal basis of this proposal, but we urge this Subcommittee to ask some fundamental questions on this topic as you consider the bill. H.R. 5637 overrides state tax laws, allows only the state of domicile of an insured party to collect premium taxes, and says that it intends for the states to create a nationwide regulatory system of non-admitted insurers. Examples of harmful, vague, incomplete, or contradictory requirements in H.R. 5637 include the following:

- The definition of "home state" in section 107(3) of the bill appears to apply the provisions of this bill to non-admitted insurance sold to individual consumers, not just companies. A home state is defined to mean the state in which an insured entity or "individual" maintains a principal residence. This provision is contrary to the stated intent of the sponsors of the bill to apply it only to the purchase of commercial coverage by sophisticated corporations. If the bill allows the growth of poorly regulated non-admitted insurance – as it is intended to do – it could seriously harm consumers who buy "personal lines" of non-admitted insurance, such as automobile or homeowners insurance (for example, to protect a home from brush fires). According to the 2005 edition of "Best's Aggregates and Averages," almost $1 billion in non-admitted personal lines premium was sold in 2004. Moreover, the operating profit of these lines was more than twice that for property-casualty insurance overall. It is entirely realistic to assume that this bill could encourage increased sales of non-admitted insurance to individual consumers. CFA strongly urges this Subcommittee to closely examine this extremely troubling section.

- Section 101 (b)(1) prohibits any state, other than the home state of an insured party, from requiring premium tax payments for non-admitted insurers. This provision does not address the collection of state fees for such purposes as market conduct and financial examinations, or the collection of fines for violations of the law. However, Section 103 allows states to collect fees related to the licensing of a non-admitted insurer if that insurer participates in a national insurer producer database developed by the National Association of Insurers (NAIC). These two provisions appear contradictory in intent. Can states other than the state of domicile collect these common fees and fines, or not? If not, does Congress have the legal authority to prohibit the collection of fees for services rendered exclusively by the states?

- Section 101 (b)(4) states that "Congress intends that each State adopt a nationwide or uniform procedure, such as an interstate compact…" for the payment and allocation of premium taxes. This extremely vague requirement, if it even is a requirement, raises some troubling questions. How does Congress intend for this system to work? What are the standards that Congress will require states to meet in the creation of this interstate system? How will Congress exercise oversight? Rather than obliquely requiring an interstate compact regarding the oversight of non-admitted insurers, the authors of this legislation should propose specific requirements to effectuate and implement such an interstate system and then seek input as to whether such a system meets Constitutional scrutiny.

The Spitzer Investigations Demonstrate that Large Buyers of Insurance (and their Customers) Need Basic Consumer Protections

Section 103(c) of H.R. 5637 reduces the already minimal state regulation of non-admitted insurance companies by forbidding any state other than the home state of an insured party from regulating non-admitted insurers that do business with that party. Section 105 "streamlines" the process of selling surplus lines insurance by permitting insured parties to procure surplus lines coverage without having to show, as most states require today, that a search of the licensed market was made and no coverage was found.

These two provisions assume that large buyers of insurance don't need protections that would normally be provided in an insurance transaction, such as protection from deceptive sales practices, unfair discrimination, and verification of legality of policy forms. The investigations and settlements pursued by New York Attorney General Eliot Spitzer refute this assumption. The nation was shocked when it learned that Attorney General Spitzer had uncovered remarkable levels of anti-competitive behavior involving the nation's largest insurance companies and brokers. The victims were the most sophisticated insurance consumers of all – major American corporations and other large buyers. Bid-rigging, kickbacks, hidden commissions, and blatant conflicts of interest were uncovered.

Attorney General Spitzer's findings are, unfortunately, a reflection of the deeply rooted anti-competitive culture that exists in the insurance industry. On the federal side, the antitrust exemption that exists in the McCarran-Ferguson Act (that is modeled by many states) has been the most potent enabler of anti-competitive practices in the insurance industry. Congress has also handcuffed the Federal Trade Commission in prosecuting, as well as even in investigating and studying, deceptive and anti-competitive practices by insurers and brokers. On the state side, insurance regulators have utterly failed to protect consumers and to properly regulate insurers and brokers in a number of key respects. Many of these regulators, for example, collaborated with insurance interests to deregulate commercial insurance transactions, which further hampered their ability to uncover and root out the type of practices uncovered by Attorney General Spitzer. Deregulation coupled with an antitrust exemption inevitably leads to disastrous results for consumers.

The Spitzer investigation reveals how easily sophisticated buyers of insurance can be duped by brokers and insurers boldly acting in concert, as they have become accustomed over the long history of insurance industry anticompetitive behavior. H.R. 5637 establishes a new regulatory regime that is, at best, complex and difficult to implement and, at worst, much less effective. It will create serious risks for large buyers of insurance and the consumers they serve. The customers of these “sophisticated” companies and insured parties are put at great risk by the use of surplus lines carriers. If the insured party and the insurer become insolvent, state guarantee funds would not be available to help these consumers (see below).

Great Regulatory Confusion and Ineptitude Would Likely Result When the State of Domicile for an Insured Party Regulates All Parts of that Entity's Insurance Transaction

As an example of how confusing and ineffectual this regulatory regime would likely be, consider how the State of Michigan might regulate insurance contracts for General Motors (GM). Let's say that GM or another large company based in Michigan has purchased a commercial automobile policy for its cars on the West Coast and Gulf Coasts from non-admitted insurers. In all likelihood, Michigan regulators know very little about dealing with earthquake risk in California or hurricane risk in Florida in pricing insurance policies, or in handling claims resulting from such weather events if GM's cars are damaged. Michigan regulators probably also uninformed about how no-fault or other unique state laws should apply to a given claim. Since Michigan is a no-fault state for auto insurance, regulators there would likely know very little about tort laws in other states and how pricing and claims should be handled. How can 50 regulators each become expert in the laws of all 50 states? This is regulatory super-complexity, not regulatory simplification. Today, each state applies its own laws to insurance transactions within its own borders. Regulators do not have to be experts about laws and insurance risk in 50 states.

H.R. 5637 includes a number of other regulatory complexities that could bring implementation of the law to a grinding halt. For example, to facilitate the proper allocation of state premium taxes, Section 101(c) gives states the authority to require brokers in other states to file tax allocation reports with that state. So, the State of Michigan could, in theory, require brokers that Michigan does not license in other states who have sold GM various surplus lines polices to file reports regarding taxes that are often adjusted <u>after</u> a contract is signed. As insurance contracts for large companies often cut across state lines, allocating tax revenues by state is very difficult. The collection of 50-state data regarding every transaction by every commercial party that purchases insurance in a particular state is a hopelessly complex process that is ripe for abuse and mismanagement, if not outright tax evasion

To make matters even more confusing, Section 102(b) appears to allow every state to license out-of-state brokers who do business with in-state companies. However, it is hard to fathom that any state other than those that are extremely large would have the resources to properly license and oversee such a large number of brokers.

H.R. 5637 Incorrectly Assumes that the Domiciled State of an Insured Party or Reinsurance Company Can Provide the Best Oversight

Section 102(c) would prohibit any state from regulating a non-admitted insurer in any way if the insurer is not domiciled in the state. Other states would be helpless to act even if their residents are harmed by clearly abusive insurance practices. Suppose a non-admitted insurer for a company like GM acts in bad faith and refuses to pay legitimate claims for unsafe automobiles that harmed drivers in Texas? The State of Texas would have no ability to investigate or sanction that insurance company while the State of Michigan, with limited resources, would have much less of an incentive to get to the bottom of the problem.

Chairman Oxley of the Financial Services Committee has stated that "choice of law" provisions like this are desirable because the state of domicile has the greatest interest in protecting insured companies. Chairman Oxley seems to have forgotten about protecting consumers and customers of an insured company. If the State of Washington, for example, has the greatest interest in pleasing Microsoft, this could be to the detriment of its residents and consumers across the country.

Another "race to the bottom" would be incited by Section 105 (mentioned above.) By allowing large commercial insured parties to seek coverage from non-admitted insurers without even determining whether the same coverage is available from an admitted carrier, H.R. 5637 will undoubtedly spur the growth of poorly regulated surplus lines carriers. State regulators attempt to ensure that licensed insurers meet certain safety and soundness and consumer protection standards that surplus lines carriers often do not have to meet. This protects both the insured entity and those served or affected by the insured entity (see below.) It is not in the public interest to foster the growth of a segment of the market that does not have to meet state standards.

The bill also presents unique problems regarding the regulation of the reinsurance industry. Section 202(a) only allows the domiciled state of a reinsurance company to regulate that company's solvency. What if insured entities in the state of domicile are covered by only one percent of the reinsurance written by a particular company but entities in another state are covered by 75 percent of the reinsurance? Why does it make policy sense to exclude the state whose citizens and businesses have the most to lose if a reinsurance company is not properly capitalized?

Moreover, allowing a domiciliary state to essentially act as a national regulator promotes forum shopping by insurers, in which companies move their official domicile from state to state to secure the most favorable regulatory environment. This spurs states to "compete" in offering the weakest oversight. The state of domicile is often under the greatest political and economic pressure not to act to end harmful business practices by a powerful in-state insurer. When CFA's Insurance Director Bob Hunter was Insurance Commissioner of Texas, he had to investigate an insolvent insurer in another state because the commissioner of that state refused to do so. Several directors of that insurer were former governors and insurance commissioners of the domiciliary state.

The Bill would Guarantee that Consumers would be Harmed in the Event that a Surplus Lines Insurer becomes Insolvent.

This is because the guaranty associations in all states do not cover claims for surplus lines insurers from other states. This may be a minor problem for the defunct policyholder and the defunct insurer, but it certainly is a problem for the people that the policyholder may have injured and are left with out guarantee association protection, such as victims of asbestos exposure.

In conclusion, let me say that the concerns that I have raised with H.R. 5637 make it very clear that the drafters of this proposal have not thought through the legal and constitutional implications raised by the bill, not to mention the harmful effects that the bill could have on the insurance market, those who buy products or services from companies that purchase surplus lines insurance or reinsurance, or even state revenues. For example, according to the Committee Report on H.R. 5637, the Congressional Budget Office (CBO) has determined that the bill will increase federal revenues (and thus decrease state revenues) by $5 to $10 million dollars a year. The CBO also says that it is uncertain how much the unfunded mandates in the bill will cost the states, but it estimates that these costs won't exceed $64 million. The bill should require the execution of a thorough GAO study on all of these issues -- as opposed to the incomplete study mandated in Section 106 -- <u>before</u> any of these provisions are enacted. It makes no sense to put this proposal on the books until more careful analysis is conducted of the bill's impact.

Thank you for the opportunity to offer CFA's comments.

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